Is Cash Flow Still Important?

Cash flow is "king" for a closely held business, but with low interest rates, abundant private equity capital and an improving economy, some may question whether our emphasis on cash flow is outdated. While this is a valid perspective, we still find that in the day-to-day world of planning for privately held companies to achieve a successful future, cash does still matter.

It is especially true when planning for a transition of ownership to insiders (children, employees, co-owners) that cash flow is the fuel that powers the entire transition process.

In Exit Planning, we typically use the following definition of "*business cash flow for Exit Planning purposes.*" Business cash flow is the portion of the annual net cash flow from operating activities that remains available for discretionary purposes (after the basic obligations of the business have been met). Because we are discussing cash flow in the context of exiting your business, the "discretionary purpose" referred to above is the purchase of your ownership in your company and/or the delivery of other financial benefits or value from your company to you.

As you prepare to transition out of your business using any type of ownership transfer method, it is imperative that you secure an accurate future cash flow model. Why?

In a sale to insiders (employees, co-owners or children), cash flow may be the source—the sole source, at least initially—of payments to you. Insiders may not have enough money of their own with which to pay you. Without significant planning and implementation, insiders may not be able to quickly acquire or borrow that cash.

Should you plan to sell part or all of your business beginning in any given year, you'll most likely start by using an objective approach to convert anticipated future business performance to a projected cash flow number in that year and at least five additional subsequent years. This analysis requires a combination of top line business forecasting with bottom line cash flow results of operations. Working with a qualified advisor to do this analysis gives it a credibility and reliability that a mere guess just doesn't have.

If you prefer to take matters into your own hands by preparing your own cash flow projection, resist the temptation to create an overly-optimistic forecast. Consider best-case and worst-case scenarios and the results that derive from each. Your projection must be grounded in the reality of past actual performance rather than in your rosy hopes for the future. To avoid this temptation, we encourage owners to work closely with a highly-skilled financial forecasting advisor.

It bears repeating here that the future cash flow of the business may be your buyer's only source (at least in the early years) of funds to pay you. If the company, during and after a transition to new ownership, cannot achieve the cash flow that you project, you may not receive the payments that you expect.

How Will You Use Projected Cash Flow?

Projecting cash flow is the first step. The second is to calculate how that cash flow will be allocated during the ownership transition. Determining the net after-tax payments to you is the goal of this exercise.

To do so, you must calculate, for each year of your Exit Plan implementation, the expected available cash flow reduced by: 1) reasonable compensation to you and 2) the cash the company must retain (for growth, working capital, etc.).

The remaining cash flow is distributed to the shareholders; this means you and—to the extent you have sold part of your company—the new owners.

New owners may use some or all of their share of that distributed cash to pay you for shares of ownership. If the projected cash flow to new owners is insufficient to pay you through an installment note on a reasonable timeline, your exit is at best temporary.

Since cash flow is the core of an Exit Plan, how do we 1) increase cash flow; and 2) use it wisely?

A successful Exit Plan minimizes taxes for both seller and buyer and keeps sellers in control until they receive full value in connection with their ownership. All plans begin with an informed understanding of current and future cash flow and require considerable planning and action to achieve owner goals. Commonly used, non-controversial tax minimizing strategies can help keep more cash in the stream heading toward current and future owners, making an exit potentially more achievable. Keep in mind that cash flow utilization strategies and tax minimization strategies over a period of time can be combined to provide you with the value you want and need while efficiently putting the company into the hands of your intended successor owner, with you in the driver's seat all the way.

Your Exit Plan is founded upon your exit objectives (*when you want to leave, how much money you want and need, and who should own the business after you*) and upon the likely future cash flow of the business. Projecting the amount of cash flow and determining how that cash flow is used is, indeed, the ultimate key to the success of your exit. However, no two business owners are the same, so we would appreciate the opportunity to talk with you about your plans for the future of your ownership and the role that projected cash flow plays in that future. For more information, visit our website at www.rjzinc.com.